THE CANADIAN CHAMBER OF COMMERCE
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# Submission to the Department of Finance Canada on Budget 2012 Foreign Affiliate Dumping Proposal

June 2012

June 6, 2012

The Honourable James M. Flaherty, P.C., M.P.
Minister of Finance
Department of Finance Canada
L'Esplanade Laurier
140 O'Connor Street
Ottawa, Ontario
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Dear Minister:

On behalf of our members, I am writing to you to express our views and concerns on the so-called "foreign affiliate dumping" proposal in Budget 2012. Additionally, we would like to offer an overriding recommendation for modifying the proposed rule as well as some specific recommendations, all with the objectives of 1) making the proposed rule less subjective, 2) ensuring it is narrowly targeted at the erosion of the Canadian tax base, and 3) making certain it does not discourage transactions that benefit the Canadian economy.

The Canadian Chamber of Commerce appreciates the opportunity to take part in these consultations. We believe that greater consultations with stakeholders prior to the introduction of draft legislation would have made the process more efficient and effective. Consultations undertaken by the Advisory Panel on Canada's System of International Taxation (2008) were good, but too general for the purpose of these legislative changes.

It is important to state up front that we believe it is reasonable for Canada to put some restrictions on debt loading, and related transactions, in Canada to protect Canada's tax base and reduce the scope of excessive debt financing of foreign investments. However, we believe that a regime that is too restrictive could make it more difficult for Canadian subsidiaries to expand their businesses (with ultimate benefit to Canada) and less attractive for foreigners to invest in Canada.

We suggest that the government adopt a more balanced approach—one that protects Canada's domestic revenue base and encourages greater competitiveness of Canadian-based multinationals.

**Background**

The Advisory Panel on Canada's System of International Taxation (2008) identified certain types of "debt dumping" transactions as being abusive. Debt dumping transactions often involve a foreign-controlled Canadian corporation using borrowed money to acquire preferred shares in another foreign affiliate from the foreign parent. Interest paid by the Canadian subsidiary on borrowed money is deductible as an expense in computing net income for tax purposes, while the dividends received by the Canadian subsidiary on the preferred shares are, in certain situations, exempt from tax in Canada. This practice inappropriately erodes Canada's corporate tax base.

The Advisory Panel recommended that a targeted measure—a specific anti-avoidance rule—be introduced to prevent tax-motivated debt-dumping transactions. The Panel stressed that the rule should be robust, easy to administer and narrowly targeted to ensure it does not impede *bona fide* business transactions that benefit the Canadian economy.

The Panel noted that transactions motivated by ordinary business considerations (for example, a foreign-controlled Canadian corporation borrowing to finance an investment outside Canada or to acquire a foreign company to expand its business) would probably generate benefits for the Canadian economy, and deductibility of interest expense should not be restricted.

**March 2012 Federal Budget**

In the March 2012 Budget, the government indicated that while the Advisory Panel identified *certain* foreign affiliate dumping transactions (i.e., debt dumping transactions) as abusive, the government also had concerns with a other types of foreign affiliate dumping transactions that it considered abusive. It therefore proposed a new rule that potentially covers all investments of a Canadian subsidiary in foreign affiliates (including corporations that become foreign affiliates as a result of the investment) unless a business purpose test, as described in the Budget, can be met. The proposed rule applies to an acquisition of a foreign affiliate's shares or debt (or an option to acquire shares or debt). The rule also applies to many transactions arising in the ordinary course of business such as making a capital contribution to an existing foreign affiliate, paying expenses on behalf of a foreign affiliate, and loaning or otherwise transferring money to an existing foreign affiliate, as well as any transaction that has a similar effect. Finally, the rule applies to indirect acquisitions undertaken through the continuance of a corporation into Canada.

The government acknowledges that distinguishing between foreign affiliate dumping transactions and legitimate business transactions that are undertaken by Canadian subsidiaries to expand their businesses is not straightforward. The business purpose test set out in the Budget is intended to assess whether an investment by a Canadian subsidiary is a *bona fide* business transaction and not for the purpose of obtaining a tax benefit.

The factors that will be given primary consideration under the business purpose test are all non-tax factors and include:

- Whether the business activities of the foreign affiliate are connected more closely to those of the Canadian company than to the business activities of the foreign parent or another non-resident member of the same corporate group;
- Whether the Canadian company fully participates in the profits of the foreign affiliate and in any future increase in value of the foreign affiliate;
- Whether the investment is made at the direction or request of the foreign parent company or any other related non-resident corporation;
- Whether the Canadian company's senior officers (who are resident in and work principally in Canada) are involved in negotiating the investment and have principal decision-making authority in respect of the investment;
- Whether the foreign affiliate's performance is more closely connected to the performance evaluation of the Canadian senior officers than to that of officers of other group non-resident companies;
- Whether the foreign affiliate's management reports to and is functionally accountable to the Canadian senior officers; and
- For share investments, whether the shares fully participate in the foreign affiliate's profits and growth.

There is no guidance on how to weigh or apply these factors. In general, the factors are intended to assist in determining whether the investment in, and ownership of, the foreign affiliate belongs in the Canadian subsidiary more than in any other entity in the foreign parent's group. Nevertheless, on May 17, 2012, at the International Fiscal Association's 2012 International Tax Seminar in Ottawa, officials from Finance Canada indicated that the Department may not issue further guidance on how these factors would be weighed or applied as it was their position that the proposal is intended to curtail certain behavior. This position underscores the importance of ensuring that the proposal is both properly targeted and carefully drafted.

If a transaction is caught by the proposed rule, the Canadian subsidiary will be deemed to have paid a dividend to its foreign parent company to the extent of any non-share consideration (cash, debt, or other property) transferred, assumed or incurred by the Canadian corporation for the acquisition of the shares of a foreign affiliate. Further, if the Canadian subsidiary issues shares to its foreign parent in connection with the transaction, the proposal would deny any paid-up capital addition to such shares. As a result, any future distributions on such shares would generally be taxed as a dividend. The immediate deemed dividend, and any future dividend resulting from the denial of paid-up capital, would both be subject to non-resident withholding tax, the rate of which may be reduced by any applicable tax treaty. Interest on money borrowed to invest in foreign affiliates will continue to be deductible, subject to thin capitalization restrictions.

The new foreign affiliate dumping rule will, if enacted as proposed, apply to transactions occurring after March 28, 2012.

**Canadian Chamber's General Comments On The Budget's Proposal**

The Canadian Chamber believes the proposed rule, as drafted, is so broad that there is a real possibility it will have unintended adverse effects for Canada. On its own, the foreign affiliate dumping proposal may discourage foreign investment because of the breadth of what it would catch, and the enormous uncertainties associated with the largely subjective business purpose test as proposed. Indeed, the primary factors to consider in applying the business purpose test will prove difficult for most foreign-controlled Canadian corporations to meet (it sets a very high threshold) or, at the very least, create a great deal of uncertainty as to whether such a test has been met.

The proposal will effectively force multinationals to reconsider their investments in Canada since any excess cash generated from such operations would either have to be left idle in Canada—an unattractive option in today's global financial environment—or be repatriated, giving rise to dividend withholding taxes and foreign country income recognition.

Canadian companies that have previously acquired foreign affiliates from their parent company or other foreign related company and wish to make additional investments in such affiliates may find the proposed rule particularly punitive.

Finally, the proposal appears to hinder a foreign-controlled Canadian corporation from restructuring—transferring shares of a foreign affiliate to a new foreign affiliate holding company; merging a foreign affiliate with a foreign affiliate holding company; or liquidating a foreign affiliate holding company and acquiring shares of a foreign affiliate as a consequence. If the proposed rule applies, the consequence would be a deemed dividend paid to the foreign parent with the consequent withholding tax implications.

In summary, the impact of the proposal is crystallizing in two distinct respects:

- For multinationals with Canadian operations, the proposal appears to effectively raise the corporate income tax rate from the government's oft-touted 25 per cent.

- Within the tax community, commentators have observed that the proposal, together with the Department of Finance's August 19, 2011 "upstream loan" proposals and the existing shareholder loan/benefit rules in subsection 15(2) of the Income Tax Act (Canada), would have the effect of turning Canada into a "tax jail" or "cash trap" for affected organizations—even in *bona fide* business transactions which do not give rise to debt dumping concerns.

We believe these impacts run counter to the government's economic action plan, *Advantage Canada*, particularly with respect to its stated objective (which we strongly support) to "lower business taxes, reduce regulatory and administrative burdens, enhance competition, ensure our capital markets are globally competitive and encourage free trade and foreign investment." Budget 2012 reinforced the importance of these objectives when the government proudly stated, "It is no surprise that *Forbes* magazine ranked Canada as the number one country in the world for doing business in 2011, citing our strong economic recovery and competitive tax system, among other factors."Given the negative impacts of the proposal on achieving the government's stated objectives, we reiterate the importance of ensuring that the proposal, and related tax measures, be properly targeted and carefully drafted.

**Canadian Chamber's Recommendations**

The Canadian Chamber of Commerce recommends that the federal government:

1. In the future, where practical, obtain adequate feedback from key stakeholders before drafting legislation. Additionally, given the real possibility the proposals will have unintended adverse effects on the Canadian economy, we urge the government to continue the dialogue it has already started and be open to making improvements in this area.

2. Draft the rules so as to allow an offshore investment where there is no material net cost to Canada's domestic revenue base.

3. Amend the foreign affiliate dumping proposal, the upstream loan proposals and subsection 15(2) to effectively allow Canadian resident subsidiaries of foreign multinationals to lend funds to non-arm's length parties without triggering withholding tax, provided such lending activities (when considered together with any directly related expenses) result in a commercial spread and, thus, net income to the Canadian subsidiary.

4. Establish sufficient safe harbour provisions so as to minimize the subjectivity of the proposed business purpose test and create more certainty.

**In Summary**

The Canadian Chamber of Commerce believes that Canadian subsidiaries of foreign controlled companies are an important part of the Canadian economy and, therefore, it is important not to unduly damage the ability of these organizations to do business globally. Otherwise, they may choose to do business in other jurisdictions.

Legislation dealing with so-called foreign affiliate dumping must, therefore, strike the right balance. Canada's business tax system should not be a barrier to Canadians growing international businesses that benefit the Canadian economy but neither should it extend some businesses tax advantages over others.

Practices that inappropriately erode Canada's corporate tax base should be discouraged.

I hope our comments have been helpful. I, along with our members, would be pleased to work with you to offer any further assistance.

Sincerely,

Perrin Beatty
President and Chief Executive Officer

cc: Ms. Nancy Horsman, Assistant Deputy Minister, Tax Policy Branch
Mr. Brian Ernewein, General Director, Tax Policy Branch
Mr. Shawn Porter, Director, Tax Legislation Division
Mr. Dave Beaulne, Senior Chief, International Outbound Investment, Tax Legislation Division
Mr. Jonathan Finkelstein, Tax Policy Advisor